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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1950

No. 413

ESTATE OF MARGARET RUTH BRADY FARRELL, Deceased, NEILE F. TOWNER, CENTRAL HANOVER BANK AND TRUST COMPANY, Executors,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT AND BRIEF IN SUPPORT THEREOF

NEILE F. TOWNER,
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COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The Estate of Margaret Ruth Brady Farrell, Deceased (Neile F. Towner and Central Hanover Bank and Trust Company, Executors), prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in the above entitled cause on June 20, 1950.

Opinions Below

The opinion of the Tax Court of the United States is reported in 12 T. C. 962. The opinion of the United States Court of Appeals for the Second Circuit is reported in 182 F. 2d 903.

Jurisdiction

On June 20, 1950 the Order for Mandate was entered in the United States Court of Appeals for the Second Circuit. By order dated September 13, 1950, signed by Mr. Justice Robert H. Jackson, the time of petitioner for filing this petition for writ of certiorari was extended to and including November 17, 1950. This Court has jurisdiction under section 1141(a) of the Internal Revenue Code.

Questions Presented

1. Whether petitioner is entitled to deduct from the gross estate of decedent in arriving at the net estate upon which the estate tax is calculated, a portion of the indebtedness represented by a certain note made by the decedent and shown in the estate tax return at $331,938.33. The portion of the indebtedness sought to be deducted is $298,538.33, the balance being concededly deductible.

2. Whether the United States Court of Appeals for the Second Circuit erred in holding that under the law of the State of New York, petitioner could obtain reimbursement from the decedent's son, Anthony, of $298,538.33 paid by petitioner in discharge of the portion of decedent's indebtedness on the note sought to be deducted.

3. Whether the United States Court of Appeals for the Second Circuit erred in holding that it had freedom to differ with and could refuse to follow the law of the State of New York, as enunciated in a decision of the Supreme Court of the State of New York which has never been overruled or even questioned in the state courts, where federal taxation, by statute, depends on the precise issue of state law there determined.

4. Whether the United States Court of Appeals for the Second Circuit erred in valuing petitioner's purported claim for reimbursement against the decedent's son,

Anthony, at the maximum value beyond which there was no possibility of recovery, when a number of other factors, especially costs of collection, determine the true value of the claim to the estate.

5. **Whether the decision of the Supreme Court of the State of New York, when rendered, in the proceeding which has been brought by petitioner against Anthony N. B. Farrell and tried on October 16, 1950, is determinative of this case.***

Statute and Regulations Involved

Internal Revenue Code:

"Sec. 811. GROSS ESTATE.

"The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated, except real property situated outside of the United States——

"(a) DECEDENT'S INTEREST.—To the extent of the interest therein of the decedent at the time of his death; * * *"

"Sec. 812. NET ESTATE.

"For the purpose of the tax the value of the net estate shall be determined, in the case of a citizen or resident of the United States by deducting from the value of the gross estate——

* * *

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* Inasmuch as Justice Taylor, who tried the case, has not as yet handed down his decision, it is not known at the time of filing this petition what his disposition of it will be. Hence there can be no discussion of this point at the present time. The question is now raised in this petition, however, in order to preserve petitioner's rights in this Court. Assuming the decision of Justice Taylor, when rendered in the near future, as expected, is pertinent to the disposition of this case, petitioner will file a supplement to this petition and supporting brief, and develop this point in greater detail.

"(b) EXPENSES, LOSSES, INDEBTEDNESS, AND TAXES. —Such amounts——

(3) for claims against the estate,

* * *

as are allowed by the laws of the jurisdiction * * * under which the estate is being administered * * *."

Treasury Regulations:

"U. S. Treas. Reg. 105, Sec. 81.10. *Valuation of Property.*—(a) General. The value of every item of property includible in the gross estate is the fair market value thereof at the time of the decedent's death * * *. The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell. * * * All relevant facts and elements of value as of the applicable valuation date should be considered in every case."

N. Y. Negotiable Instruments Law:

"Sec. 7. LAW MERCHANT; WHEN GOVERNS.

"In any case not provided for in this chapter the rules of the law merchant shall govern."

"Sec. 55. LIABILITY OF ACCOMMODATION PARTY.

"An accommodation party is one who has signed the instrument as maker, drawer, acceptor or indorser, without receiving value therefor, and for the purpose of lending his name to some other person. Such a person is liable on the instrument to a holder for value, notwithstanding such holder at the time of taking the instrument knew him to be only an accommodation party."

Statement

The facts as found by the courts below and otherwise appearing of record may be summarized as follows:

Beginning in 1926, the decedent's son, Anthony N. Brady Farrell obtained cash on three months' notes in the total amount of $325,550 from The National Commercial Bank and Trust Company of Albany. All these notes were made by Anthony and endorsed by the decedent, except one which was made by the decedent and endorsed by Anthony. These separate notes were renewed in similar form from time to time until they were replaced from 1929 to 1931 by notes made by the decedent and endorsed by Anthony as payee-indorser.

At the time of these replacements, it was the practice of The National Commercial Bank and Trust Company to have all guarantee endorsers and accommodation indorsers appear as payee-indorsers.

In 1932 and 1933 the decedent executed three additional notes, endorsed by Anthony, in the sum of $33,400, Anthony receiving the cash on them.

All the above notes were renewed from time to time until in 1937 they were consolidated (less a small payment on account) into a single note for $357,400 made by Mrs. Farrell and endorsed by Anthony. This note was renewed from time to time, the amount due being reduced to $332,400 by reason of a payment made by decedent in 1941. The last renewal note was dated May 24, 1944 and matured on August 24, 1944 after the decedent's death which occurred on August 14, 1944.

About 1939, the decedent had turned over her business affairs to Neile F. Towner, an attorney and now one of the executors of the estate. When Mr. Towner made an inventory of Mrs. Farrell's assets, he discovered that the three notes totaling $33,400, mentioned above were executed after the gift tax went into effect. He questioned the decedent about these three notes and asked her about the transaction.

She told him, "That is my debt. I will think it over and I intend to pay it, and Anthony is under no obligation whatsoever to pay the note."

With respect to the three notes, Mr. Towner told Mrs. Farrell that she should have included them in a gift tax return. She replied that she was not a business woman and not familiar with the gift tax. He advised her that the proper way to handle the matter was to have Anthony give his three notes to decedent for the three notes executed after June 6, 1932, plus interest thereon. Pursuant to this advice the decedent did obtain three demand notes from Anthony payable to her order with interest. These notes were executed and delivered because the original notes had been executed after the gift tax went into effect.

After Mrs. Farrell's death, Anthony, over objection and upon the insistence of the executors, paid these three notes as part of his total indebtedness to the estate of $723,174.55 (Resp. Exhibit E, Schedule C., R. 63).* The amount of these three notes paid by Anthony is the item allowed as deductible by the Commissioner.

The Executors paid the entire amount of the note with interest, to the Bank without further claim for reimbursement from Anthony. In the estate tax return deduction was claimed for $331,938.33, the amount payable at the date of death after credit for unearned discount. No demand was made by The National Commercial Bank and Trust Company upon Anthony.

The officer of the Bank who had made all arrangements at the time the replacement notes were given by the decedent and endorsed by Anthony, and who had full knowledge of the transaction, died in 1937.

Upon Mrs. Farrell's death, Anthony received approximately $6,000,000 under his grandfather's will and was financially able to satisfy the original debt.

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* Record references are to pages of the Appendix to Petitioner's Brief in the Court of Appeals, and to the Proceedings in U. S. Court of Appeals, Second Circuit, appended thereto.

On these facts the Tax Court found that decedent "never made an effective gift to Anthony of the amount of the original indebtedness nor of her right to be reimbursed if she were required to pay the notes in question." The United States Court of Appeals for the Second Circuit affirmed on appeal, stating, "the Tax Court was correct in its finding that decedent had never made an effective gift of the amount of the indebtedness or of her right to be reimbursed." The Court of Appeals also rejected petitioner's contention that factors in addition to Anthony's financial ability to pay should be considered in determining the value to the estate of its claim against Anthony, stating: "It would be absurd to hold that the value of the estate's claim against a financially responsible obligor is less than the amount of the notes, and thus to allow the estate a deduction for the difference."

After the Tax Court rendered its decision, the Executors of the Estate of Mrs. Farrell deemed it their duty immediately to institute an action for indemnity against Anthony in the courts of New York. Because the calendar of the New York Supreme Court was far in arrears, the action did not come on for trial until this Fall. Originally set down for trial on September 26, 1950 before Mr. Justice Murray, the trial was re-scheduled due to his untimely death on September 20, 1950. The case was tried, however, on October 16, 1950 before Mr. Justice Taylor, whose decision is expected momentarily. Although other issues were raised, the decision of that case will in all likelihood be determinative of the major issue of New York law on which taxation in this case depends.

Reasons for Granting the Writ

1. The Court of Appeals and the Tax Court completely misconceived the New York law properly applicable to the facts. They decided this case through an application of the law of gifts of tangible personal property, when no tangible

personal property exists in this case which could be the subject of an inter vivos gift. Because the Court of Appeals failed and refused to consider the issues under the properly applicable New York law of negotiable instruments, suretyship and quasi contracts, petitioner has been denied the deduction rightfully due it for "such amounts * * * for claims against the estate as are allowed by the laws of the jurisdiction * * * under which the estate is being administered * * *." I. R. C. Sec. 812 (b)(3).

2. Contrary to statute, the Court of Appeals asserted freedom to differ with and refuse to follow the only applicable local decision in deciding an important question of state law on which taxation in this case depends. The local decision has never been questioned, criticized or overruled since it was rendered by the Supreme Court of the State of New York in 1940.

3. Contrary to statute, regulations and decisions concerning the valuation of analogous claims included in gross estate, the Court of Appeals refused to consider any factor other than the ability of the purported debtor of the estate to pay. The true value of the claim to the estate is of course much less. Court costs, attorneys' fees, other expenses of collection and the possibility that the estate might lose should all be considered in determining the value of the offset against the estate's certain and unquestioned liability.

4. The questions raised by this case are important ones in the administration of the Federal Estate Tax Law. The problem raised by the Court of Appeals' refusal to follow state law as declared in the decision of a competent state tribunal will be a recurring one, for the incidence of both the income tax and the estate tax is often made dependent by Congressional mandate upon the statutory and decisional law of the several states. The decision of the Court of Appeals is obviously contrary to Congressional intent, and raises anew in the tax field the issues set at rest in the

field of diversity jurisdiction by this Court's line of decisions, beginning with *Erie R. R.* v. *Tompkins*, 304 U. S. 64 (1938), and departs from the policies established therein.

The valuation issue in this case is another important question of the tax law which has not been, but should be settled by this Court. The device of "offsetting" otherwise valid deductions for claims against an estate is a judicial gloss on the statute. This Court should, in its supervisory capacity, ensure that the offset rule is administered by the courts in accordance with Congressional policy, as clearly set forth in the statute and regulations governing the analogous problem of valuing claims included in gross estate.

5. A brief, supporting and amplifying the arguments herein made, is annexed hereto.

Conclusion

For the above reasons as amplified and supported in the brief annexed hereto, it is respectfully submitted that this petition for a writ of certiorari should be granted.

Respectfully submitted,

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HEWITT A. CONWAY,
Of Counsel.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

ARGUMENT

POINT I. The Court of Appeals completely misconceived the New York law properly applicable to the facts.

The issue presented by this case is whether, under New York law, the Estate of Mrs. Farrell, petitioner herein, can obtain indemnity from the decedent's son, Anthony, for the amount paid by the estate to The National Commercial Bank and Trust Company of Albany in discharge of the estate's admitted obligation to the Bank.

Under controlling New York law, following long-settled common law doctrines, the estate's cause of action is equitable in nature and based on the law of suretyship, a subdivision of the law of quasi contracts. *Decker* v. *Pope*, 1 Selwyn's Nisi Prius (13th ed.) 91 (1757); *Hunt* v. *Amidon*, 4 Hill 345 (N. Y. 1842); *Blanchard* v. *Blanchard*, 201 N. Y. 134 (1911); *Ely* v. *Stone*, 173 Misc. 117 (Sup. Ct. N. Y. Co. 1940).

Under the doctrine of these cases, the estate must prove three things by a preponderance of the evidence to recover from Anthony, first, that Mrs. Farrell signed the renewal note paid by the estate as accommodation maker, second, that the estate conferred a benefit on Anthony in paying the note, and third, that retention of the benefit by him is unjust and inequitable under the circumstances, i.e., it must prove that the estate's equitable rights to the money are superior to his. *Callery* v. *Lyons*, 292 N. Y. 15 (1944); *Hunt* v. *Amidon*, 4 Hill 345, 348-49 (N. Y. 1842); *Miller* v. *Schloss*, 218 N. Y. 400, 407 (1916); *Woodward, The Law of Quasi-Contracts*, §§ 7, 9 (1913).

As to the first requirement, the decedent was prima facie liable to Anthony on the renewal note. The estate would

have to prove, first, that Mrs. Farrell and Anthony understood and agreed as between them that Mrs. Farrell should not be held liable on the original notes made by Mrs. Farrell and endorsed by Anthony, and second, that "that arrangement and understanding was in the minds of the parties when the renewal note, the one in suit" was signed by Mrs. Farrell and endorsed by Anthony. *Callery* v. *Lyons*, 292 N. Y. 15, 19 (1944). The estate obviously could not discharge this burden, for the only evidence on the state of mind of Mrs. Farrell in signing the renewal notes was her statement that the debt was hers and that Anthony was under no obligation to pay. Because of the Court of Appeal's erroneous application of gift law to this case, it completely failed to address itself to this point under the New York law of negotiable instruments.

Assuming, however, that Mrs. Farrell did sign the renewal note paid by the estate as accommodation maker, that does not dispose of the issues under the applicable New York law of suretyship and quasi contracts. The case of *Ely* v. *Stone*, 173 Misc. 117 (Sup. Ct. N. Y. Co. 1940) is the only case in New York which has dealt specifically with the suretyship question herein raised—the equitable right of the estate of an alleged accommodating party to obtain indemnity from the party accommodated, when for reasons satisfactory to the decedent, he did not wish to hold the accommodated party liable. *Ely* v. *Stone* held emphatically that there could be no recovery. The facts of *Ely* v. *Stone* and of the present case are identical on this point. There the decedent wrote a letter stating that the account was closed out satisfactorily. Here the decedent stated explicitly and forcefully that the debt was hers and that Anthony was under no obligation whatsoever to pay the note. In neither case can the estate show it inequitable for the alleged accommodated party to retain the benefits conferred on him. This is precisely the result desired by the decedents, from whom the causes of action were derived.

The reason the estates cannot recover is not because of a "gift by waiver", as suggested by the Court of Appeals.

The estates cannot recover because they cannot prove a necessary element of the cause of action upon which recovery depends—superior equitable rights to the money, *Ely* v. *Stone, supra.*

As appears from the following quotation, the Court of Appeals and the Tax Court did not consider the facts in relation to the above principles. Their decisions were based on the law of gifts of tangible personal property:

> "Under controlling New York law some definitive action by Mrs. Farrell to evidence and effectuate her intent was necessary before Anthony could be relieved from liability. *Re Van Alstyme,* 207 N. Y. 298, 100 N. E. 802; *Farmers' Loan & Trust Co.* v. *Winthrop,* 238 N. Y. 477, 144 N. E. 686; *Doty* v. *Willson, supra* [47 N. Y. 580]. And the burden of proof is on the taxpayer. Since petitioners failed to satisfy this burden of showing such definitive action to evidence an intent to relieve Anthony from liability, the Tax Court was correct in its finding that decedent had never made an effective gift of the amount of the indebtedness or of her right to reimbursement." R. 97, 182 F. 2d 903, 906.

In none of the cited cases was there any issue as to the right of a surety to indemnity. In no New York case, so far as exhaustive research has disclosed, has a New York court ever intimated that the law of gifts is applicable to determine a surety's or his estate's rights to reimbursement. Certainly the courts below pointed to none, and, indeed, *Ely* v. *Stone* holds directly to the contrary.

The law of gifts of tangible personal property can have no application to this case because no tangible personal property is involved. During her life and at her death Mrs. Farrell had no property right of any kind growing out of these transactions, as against Anthony, which could be the subject of a true gift to him. The note paid by the estate to the Bank certainly did not constitute a property right, for it did not represent any indebtedness of Anthony to Mrs. Farrell. On the contrary, Mrs. Farrell's promise as

maker runs to Anthony as payee-indorser on the note (R. 43). Mrs. Farrell or her estate could not sue Anthony *on the note* either before or after the indebtedness was paid the Bank. *National Citizens Bank* v. *Toplitz,* 81 App. Div. 593 (1st Dept. 1903). Nor did the right to reimbursement—certainly intangible because not represented by any note of Anthony's or other writing—achieve the status of a property right during Mrs. Farrell's life. What the Court of Appeals asserted to be a proper subject of an inter vivos gift of tangible personal property was no more than an intangible, potential equitable right of reimbursement from Anthony which could accrue and become property only if and when Mrs. Farrell paid the debt. This, in fact, she never did. A property right to reimbursement arose, if at all, only in favor of the estate upon payment by it of the note after the decedent's death.*

The impossibility of applying the law of gifts to this case is well shown in the opinion of the Court of Appeals itself. In referring to a New York gift case which discussed the well-settled requirement that the holder of a note of a debtor must destroy, cancel or surrender it to the debtor to effect a valid gift of the indebtedness to him, the court below wrote:

> "Here, however, we have the quite different situation of a written note always in existence, never surrendered or cancelled, on which the mother acted as a mere accommodation party for her son. A significant act evidencing the claimed gift is therefore lacking." R. 95, 182 F. 2d 903, 906.

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* Curiously, the fact that Mrs. Farrell owned no property right against Anthony at the time of her death has been recognized by the Government, as is demonstrated by the manner in which this deficiency is asserted. The value of the right of reimbursement is not included in gross estate under Section 811 as property of the decedent at the time of her death, for it cannot be. It is "included" by the double negative device of "offsetting" and "disallowing" a deduction.

Aside from the fact, as noted, that Anthony was not indebted to Mrs. Farrell on the note, the note was owned by and in the possession of the Bank. How could Mrs. Farrell cancel it, destroy it, or surrender it to Anthony?

POINT II. Contrary to statute, the Court of Appeals refused to follow the only applicable local decision in deciding an important question of state law on which taxation in this case depends.

The Court of Appeals noted the case of *Ely* v. *Stone, supra,* and then explicitly refused to follow it, giving as its reason:

> "As this Court recently observed in *Lembke* v. *United States,* 2 Cir., 1950, 181 F. 2d 703, a federal court has some freedom to differ with the decision of a single trial judge in a state court at least where we are applying federal legislation rather than exercising diversity jurisdiction." R. 98, 182 F. 2d 903, 907.

Although this proposition may be correct where the meaning of a federal statute is in question, it can certainly have no application to the type of federal legislation here involved, which specifically refers to "the laws of the jurisdiction * * * under which the estate is being administered * * *." I. R. C. §812(b). In directing federal tribunals to applicable state law, Congress gave no intimation of an intent to empower them to agree or to disagree with the decisions of competent state courts, as they might see fit. The implication is quite the contrary.

In the *Lembke* case, the Court of Appeals stated the reason for the rule that a federal court in a diversity case must follow the decision of a state trial court, absent higher authority: "* * * it is inadmissible that there should be one rule of state law for litigants in the state courts and another for litigants who bring the same question before

the federal courts sitting within the state." When the incidence of a federal tax is made to depend on local law by the express mandate of Congress, the same policy considerations forbid that one rule of law be applied in a tax proceeding and another in a state court proceeding. The case at bar well illustrates the dangers of injustice inherent in a departure from such a fundamental rule of tax administration. If, as is by no means improbable, the case of *Ely* v. *Stone* is followed in the action which has been tried in the state courts, the estate will recover no part of the $300,000 alleged to be due from Anthony Farrell, the decedent's son. But if the judgment of the Court of Appeals, refusing to follow *Ely* v. *Stone*, stands, the residuary legatees, of whom Anthony is not one, will have to bear the burden of approximately $160,000 in additional taxes. An intent that federal courts should be able to bring about such an inequitable result by disagreeing with and refusing to follow a local decision which has never been overruled or even questioned in the state courts, cannot be imputed to Congress.

POINT III. The Court of Appeals erroneously affirmed the Tax Court's valuation of the estate's claim for reimbursement in an amount which the estate could not possibly realize in full.

The scheme of the estate tax law is to include the value of all assets of the decedent at the time of his death in his gross estate under Section 811. Section 812 then provides for deductions from gross estate to arrive at net estate, on which the tax is calculated. Among the permitted deductions is one "for claims against the estate * * * as are allowed by the laws of the jurisdiction * * * under which the estate is being administered * * *."

In order to avoid absurd results, the federal courts have refused to follow the statutory scheme literally. Thus they

refuse to permit a deduction from gross estate for a bona fide claim against the estate, when immediately on payment of the claim, there arises in favor of the estate a corresponding undisputed claim over against another. The typical case arises when the estate pays an obligation for which it is secondarily liable, i.e., as surety. In this situation, the estate's claim against the principal debtor cannot be included in gross estate as an asset of the decedent, because, not having discharged the obligation in his lifetime, he possessed no claim agaist the principal debtor at the time of his death. The claim over arises only after death and in favor of the estate upon payment.

To avoid the anomalous result of permitting a full deduction for claims against the estate when the estate could collect the identical amount from another, the courts have thus far allowed deductions only to the extent that they are not "offset" by a right of action against a financially responsible principal debtor. By the "offset" device, assets of the estate are properly made subject to tax, through the denial of a deduction from gross estate, rather than an addition to gross estate.

The "offset" serves exactly the same purpose and achieves exactly the same result as an inclusion in gross estate. No reason is apparent why the offset should be valued differently from other assets of the estate and petitioner so argued in the Court of Appeals. Yet the Court of Appeals held to the contrary, stating:

> "It would be absurd to hold that the value of the estate's claim against a financially responsible obligor is less than the amount of the notes, and thus to allow the estate a deduction for the difference." R. 99, 182 F. 2d 903, 907.

The same argument could be applied to the valuation of any asset of an estate. The Regulations (Reg. 105, Sec. 81.10(a)), however, clearly specify that only the fair market

value of property belonging to the decedent is to be included in the gross estate.*

In *Estate of H. E. Barneson*, 4 T. C. Mem. 427 (1945), the Tax Court applied the method of valuation set forth in the Regulations to a claim for refund of income taxes. The Court wrote:

> "Obviously, [a prospective purchaser] would not have paid a price equal to the maximum amount beyond which there was no possibility of recovery. Even if he believed that he could recover the maximum amount, he would consider that some allowance must be made for his court costs and attorneys' fees, and that he was entitled to a fair amount as a profit. In addition to these factors he would consider the probability of an unfavorable result in the District Court. * * * The purchaser would have to consider whether he could prove [necessary] facts."

In the *Barneson* case, of course, there was no question of the Government's ability to pay. Yet the Court quite properly considered other matters influencing value.

Both the Tax Court and the Court of Appeals in this case considered only one factor in valuing the offset—the financial ability of Anthony to pay. Yet only highly speculative purchasers would take an assignment of the estate's claim against Anthony, knowing of his previous resistance to paying other claims of the estate against him, and knowing of the uncertainty and improbability under New York law of recovering anything from Anthony.

Valuing the estate's tenuous claim against Anthony equally with the estate's admitted and certain liability to the Bank is grossly unfair to the estate. The estate is

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* "* * * The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell. * * * All relevant facts and elements of value as of the applicable valuation date should be considered in every case."

charged with the value of assets which it could never possibly realize in full. Court costs, attorneys' fees, and the possibility of not being able to recover from Anthony at all—these factors must all be estimated and deducted from "the maximum amount beyond which there [is] no possibility of recovery" before the true value of the offset to the estate can be determined.

Respectfully submitted,

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